ROBUST AUDIT PLANNING (PART 1)

Going Beyond Form/Checklist Filling

BY
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Rachel[1] was a young and self-motivated audit assistant who joined a 15-headcount small and medium-sized practice (SMP) three months ago. She completed two audit engagements under the guidance of an audit senior, which gave her a great sense of accomplishment. In that three-month period, Rachel had also completed the ISCA Practical Audit Workshop (PAW) which gave her morale another boost. She was grateful to her audit partner for the training opportunity and looked forward to applying her newly-acquired knowledge on the next audit engagement. To her delight, her audit manager assigned to her an audit engagement which was, in the words of the manager, "more challenging than her past two engagements". She felt valued and told herself that she would give it her best shot.

The next morning, Rachel went to collect the past year's audit working papers as instructed by her manager. She was eager to learn about the auditee company (auditee) from her manager. She knew that it was a

[1] Not her real name

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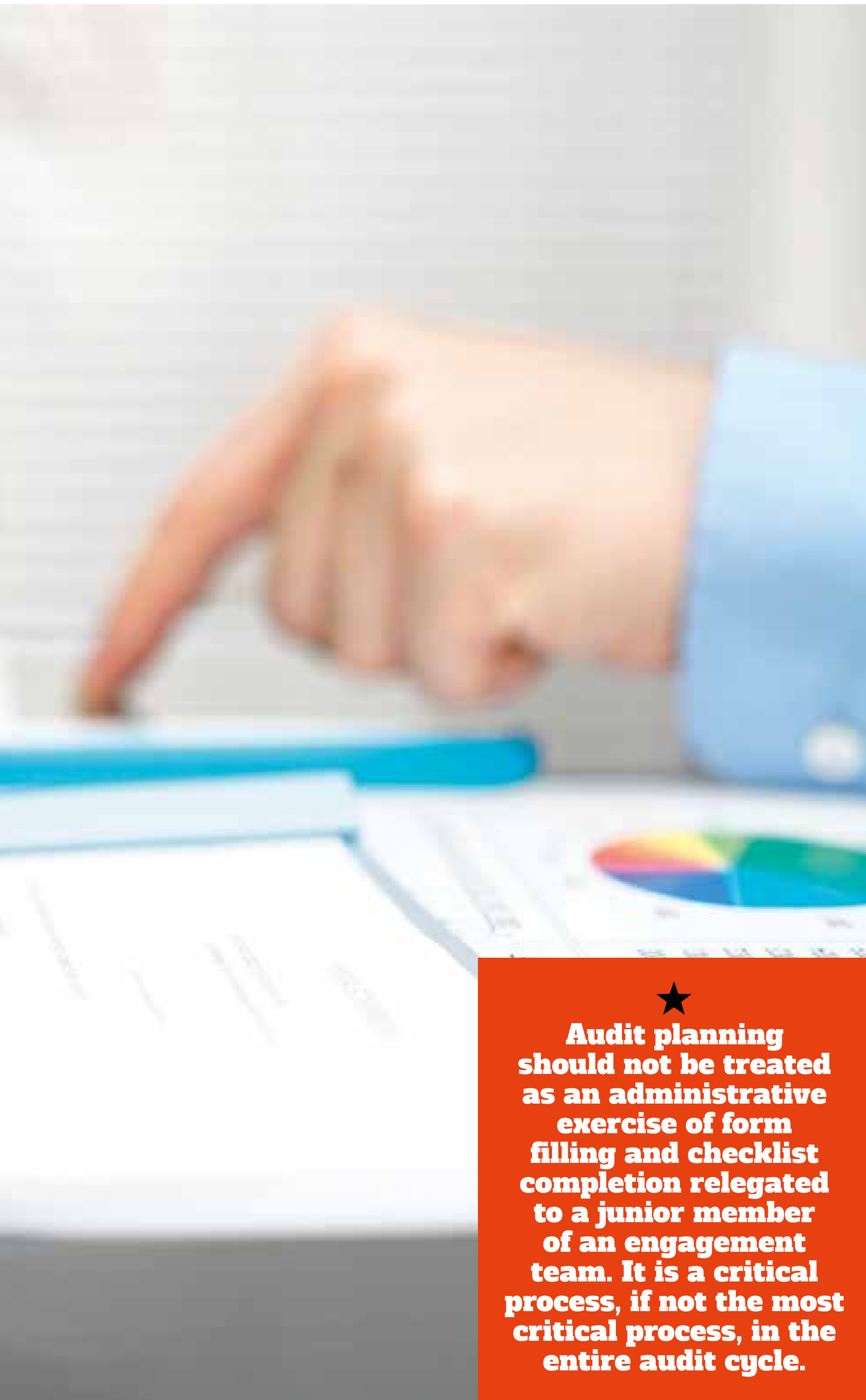

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recurring audit engagement which the manager had worked on in the last five years. Unfortunately, the manager mumbled under his breath about having to rush off to "fire-fight" another engagement and informed Rachel to "just follow prior year working papers". Rachel was left to her own devices. She recalled that at the recent PAW she attended, the workshop facilitator had emphasised the importance of risk identification and assessment when developing an audit plan which should be performed prior to commencement of an audit. Hence, she flipped through the prior year's working papers, hoping to find some documentation on the risks identified and assessed. Tough luck! There was no such documentation in the audit file.

Rachel plucked up her courage to approach her audit partner. She knocked on the door of his office and found him solemnly reviewing some working papers behind a huge pile of files, his brows knitted. When he looked up and saw Rachel, his face softened into a smile and he seemed pleased. He remembered that Rachel was an accounting graduate whom he had successfully convinced to join his practice three months ago. Rachel expressed her gratitude to the partner for sending her to PAW and then went on to ask him about the areas of focus for her newly-assigned engagement. The partner could see Rachel's excitement but she had come at a bad time. He was under pressure to sign-off two sets of accounts in the afternoon. Hence, he only advised Rachel to "pay attention to inventories because the inventory records have always been messy", based on his past 10 years' of experience with the auditee. "Everything else should be the same." The conversation ended there and Rachel took her leave.

To cut a long story short, Rachel completed the audit engagement. She incurred a significant amount of time testing a huge sample of inventories and cost of sales but at the expense

of other financial statement areas. She had also quantified the costing errors and made the necessary audit adjustment. However, at the back of her mind, Rachel had this nagging feeling that she might not have properly identified and assessed all the key risks on this engagement, let alone addressed them.

She did not know how to do it, and could not consult her audit manager who was busy "fire-fighting" another engagement. She consoled herself by rationalising that as her audit partner had only told her to "pay attention to inventories", and she had done exactly as instructed, it should be fine.

Fast forward two years. In the midst of serving her two-month notice period, Rachel heard from her colleagues that the very same engagement she had audited two years ago was selected for regulatory inspection and there were "serious findings" raised by the inspectors. Her heart sank and she felt dejected.

Believe it or not, this could be a common scenario at some SMPs. The question we should ask ourselves is: Could this have been prevented? And how? The answer is that effective audit planning has a big role to play to prevent a public accountant (PA) from facing a similar fate.

PLANNING IS NOT A MERE ADMINISTRATIVE EXERCISE

Audit planning should not be treated as an administrative exercise of form filling and checklist completion relegated to a junior member of an engagement team. It is a critical, if not the most critical, process in the entire audit cycle. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit, and continues until the completion of the current audit engagement.

In a nutshell, audit planning is about identifying the risk of material misstatements to the financial statements to ensure that any

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material misstatements are detected and corrected or if not corrected, addressed in the audit report in the form of an audit qualification. A well-developed audit plan, when properly executed, would therefore reduce the risk of a PA failing to detect material misstatements and forming an incorrect opinion on the financial statements. Hence, it is in the interest of a PA to make a concerted effort to plan for each and every one of his audit engagements. Of course, the extent of time and effort required for planning each audit engagement varies, depending on the size and complexity of the engagement; for instance, a small, low-risk trading company would require much less planning time compared to a mid-sized construction company.

PLANNING SHOULD ALSO BE PERFORMED ON RECURRING AUDITEES

PAs have a tendency to omit planning for recurring auditees especially those auditees which have engaged their services for a number of years. More often than not, the "same as last year" mindset is conveniently adopted. This is not appropriate because an auditee's business model and its operations change over time, and the environment in which it operates also evolves; consequently, risks would change and so should the audit plan. Just because clean audit opinions were issued in the past audits does not mean that the same audit strategy and plan can be conveniently adopted for the current and future audit engagements. Due consideration should be given to the new risks arising from the changes to the auditee's business and operating environment. The following case is used to illustrate this point.

Company ABC Pte Ltd (CO ABC) is a company trading in specialised equipment and tools. Its purchases are mainly from a manufacturer in Japan. In the year of audit, CO ABC lost a major customer which has resulted in its inventory build-up because it was not able to find new customers to buy its inventories. It was also the third consecutive year CO ABC incurred a net loss. To tide the company over the tight cash flow

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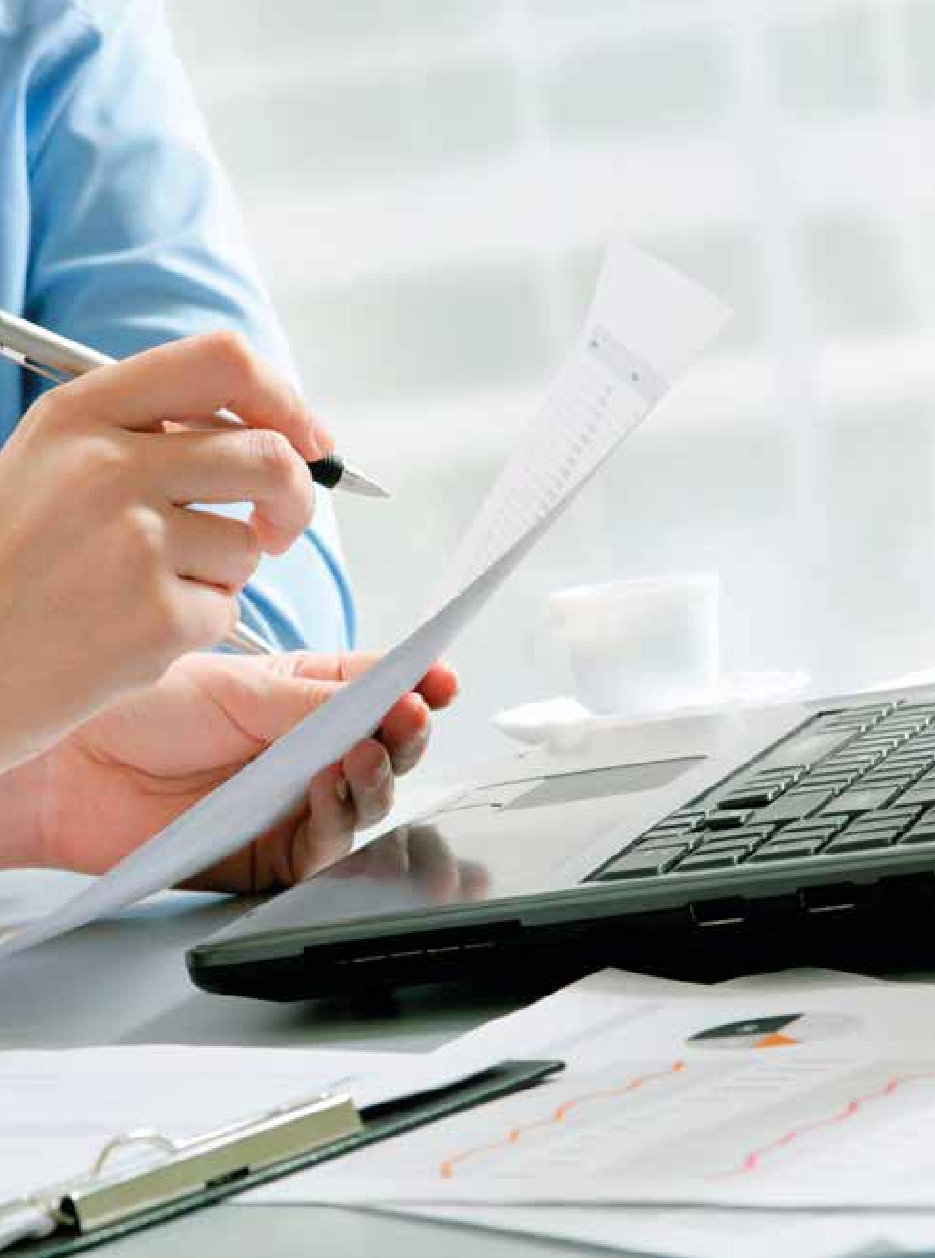

situation, the management pledged the company's shophouse to a bank for a loan amount with a two-year repayment term. Numerous audit adjustments were made in last year's audit. In addition, in the current year, CO ABC was sued by another major customer for compensation due to a substantial delay in the delivery of goods. The company's managing director (MD) has been given the mandate to turn the company around and in return, he was also given free rein to run the company as he deems fit. His compensation is tied to the sales and profit of the company. The Finance Manager, who reports to the MD, continues to be responsible for approving the claims made by the MD.

Because of the various developments in CO ABC in the current year, concerns ought to be raised at the planning stage; new risks ought to be identified and assessed, and appropriate procedures should be designed to address these risks. The additional risks identified would include, but are not limited to, the following:

- Risk of inappropriate use of going concern assumption given that CO ABC lost a major customer during the year, had difficulty selling its inventories and incurred net loss for three consecutive years;
- Risk of impairment of fixed assets and the risk that the loan covenant will be breached if an impairment charge is recognised;
- Risk of management override of controls: The MD has been given full autonomy to run the company and his claims are approved by the Finance Manager, who reports to him;
- Risk of inflation of sales as his compensation is tied to the sales and profit achieved by the company;
- The numerous audit adjustments could suggest an incompetent finance team or poor internal control over the financial reporting closing process, and there is therefore the risk of further undetected misstatements;
- Risk of a potential liability arising from the legal suit by the company's customer not recognised, or a contingent liability not disclosed.

It should be clear from the CO ABC case that if the engagement team adopted the "same as last year" audit approach, the team would likely fail to identify and address the new risks of material misstatement arising from the developments in the company. It therefore cannot be emphasised enough that without proper audit planning, a PA runs the risk of issuing a wrong audit opinion.

Planning does not stop at risk identification and assessment. It should include the development of a robust audit plan encompassing all the properly-designed audit procedures to detect any material misstatement arising from the risks. A PA should lead the design of such audit procedures because without an effective audit plan and proper execution of the plan, the effort spent on risk identification and assessment would go down the drain. ISCA

Part 2 of this two-part series will focus on the planning activities PAs should engage their auditees and their staff in to facilitate an efficient and effective audit, and more importantly, to ensure the issuance of an appropriate audit opinion.

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